STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Amended:	**02/28/11**	Bill No:	**Assembly Bill 218**
Tax Program:	**Sales and Use Tax**	Author:	**Wieckowski**
Sponsor:	**Author**	Code Sections:	**RTC 6377.1**
Related Bills:	**AB 204 (Halderman)** **AB 303 (Knight)** **SB 47 (Alquist)** **SB 395 (Dutton)**	Effective Date:	**Upon enactment**

BILL SUMMARY

This bill would provide a partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by persons engaged in manufacturing and software production, as specified and defined.

The bill would impose an estate tax[1] upon the transfer of property of every decedent with an estate valued at more than $1 million and make Legislative findings regarding the use of revenue generated to supplant the General Fund revenue lost from the exemption of manufacturing equipment.

Because this bill would amend an initiative statue, it would require approval by voters at a statewide election.

This analysis only addresses the provisions that impact the BOE.

ANALYSIS

CURRENT LAW

Under current law, business entities engaged in manufacturing, research and development, and software producing activities that make purchases of equipment and supplies for use in the conduct of their manufacturing and related activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by these entities in their manufacturing and related activities.

The statewide sales and use tax rate (8.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional transactions and use taxes (also known as district taxes) are levied by various local jurisdictions and are not reflected in this chart):

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[1] Revenue and Taxation Code Section 13301 was added by Proposition 6 by voters at the June 8, 1982 statewide primary election. Among its provisions, Proposition 6 eliminated the state's Inheritance and Gift Tax law, but imposed a California estate tax, commonly referred to as the "pick up tax," which was equal to a certain portion of the maximum allowable amount of credit for state death taxes allowable under the applicable federal estate tax law. Due to changes in federal law, the pick up tax became inoperative as of January 1, 2005.

Rate	Jurisdiction	Purpose/Authority
5.00%	State (General Fund)	State general purposes (RTC Sections 6051, 6051.3, 6201, and 6201.3)
1.00%	State (General Fund)	State general purposes (RTC Sections 6051.7 and 6201.7, operative 4/1/09 through 6/30/11)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
8.25%	Total Statewide Rate	

PROPOSED LAW

This bill would add Revenue and Taxation Code Section 6377.1 to the Sales and Use Tax Law to provide a partial exemption (General Fund only) from the sales and use tax rate of 6% (5% on and after July 1, 2011) for the following purchases made by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, component parts, contrivances such as belts and shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified persons who will then use the property as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a storage facility in connection with the manufacturing process.

The bill would define a "qualified person" as any person engaged in manufacturing activities, as described in the North American Industrial Classification System (NAICS) codes 3111 to 3399, and software production activities as described in NAICS codes 5112, or an affiliate of a qualified person, as defined.

"Fabricating," "manufacturing," "primarily," "process," "processing," "refining," are defined and the tangible personal property intended to be included or excluded from the proposed partial exemption are described.

The bill would specify that the proposed exemption would *not* include (1) any tangible personal property that is used primarily in administration, general management, or marketing, (2) consumables with a normal useful life of less than one year, except for fuels used or consumed in the manufacturing process, and (3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The proposed exemption shall not apply to any taxes levied pursuant to Sections 6051.2 and 6201.2 (Fiscal Recovery Fund), 6051.5 and 6201.5 (Local Revenue Fund), and pursuant to Section 35 of Article XIII of the California Constitution (Local Public Safety Fund). In addition, the bill specifies that the exemption shall not apply to any tax levied by a county, city, or district pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law (also known as district taxes).

The bill also provides the following Legislative intent:

> “Section 1. (a) It is the intent of the Legislature to propose an amendment to Proposition 6, an initiative measure enacted by the voters at the June 8, 1982, statewide primary election (hereafter the initiative measure).
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> (b) It is the intent of the Legislature, in proposing this amendment to the initiative measure, to provide a state sales and use tax exemption for purchases of manufacturing equipment used in the manufacturing process. It is further the intent of the Legislature, in proposing this amendment, that the revenue generated from a proposed estate tax be used, in whole or in part, to supplant the reduction of General Fund revenue as a result of the exemption for purchases of manufacturing equipment used in the manufacturing process.
>
> (c) This act shall be known and may be cited as the Job Retention and Economic Recovery Act.”

As a tax levy, the bill would become effective immediately, but would become operative only if approved by the voters at the next statewide election. The next scheduled statewide election is February 2012.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided a partial (General Fund only) sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal “Standard Industrial Classification” (SIC) codes. The exemption provided a state tax portion for sales and purchases of qualifying property, and the income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property was similar to the property described in this bill – depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Qualified property also included tangible personal property purchased by a contractor, as specified, for use in the performance of a construction contract for the qualified person who would use that property as an integral part of the manufacturing process, as described. Certain special purpose buildings were included as "qualified property," as this bill proposes. New manufacturers could either receive the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by the Employment Development Department) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (it was less than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

Since the expiration of the partial exemption of manufacturing equipment, numerous bills have been introduced to either reinstate or to expand or modify the exemption, but failed to pass. A sample of bills introduced during the last three Legislative Sessions include the following:

Bill No.	Session	Author	Proposed Exemption
AB 810 and AB 829	2009-10	Caballero	Qualifying tangible personal property, including sustainable development equipment investments, by persons engaged in manufacturing, research and development, and software publishing
AB 1719	2009-10	Harkey	Reinstate the original exemption for qualifying tangible personal property by new trades or businesses engaged in manufacturing
AB 1812	2009-10	Silva	Qualified tangible personal property by persons engaged in manufacturing and software production
AB 2280	2009-10	Miller	Equipment by manufacturers engaged in manufacturing activities
SB 1053	2009-10	Runner	Qualifying tangible personal property by persons engaged in manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	Qualifying tangible personal property by persons engaged in specific manufacturing and software production activities
SBx6 8 and SBx6 44	2009-10	Dutton	Qualifying tangible personal property by manufacturers and software publishers and affiliates engaged in manufacturing activities or research and development
AB 1152	2007-08	Niello	Qualifying tangible personal property by persons engaged in manufacturing and software production
AB 1206	2007-08	Smyth	Machinery and equipment used in research and development activities
AB 1681	2007-08	Houston	Qualified tangible personal property for use by qualified persons engaged in manufacturing, telecommunications, and electrical generation activities
AB 344	2005-06	Villines	Qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities. Would apply to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter.
AB 1580	2005-06	Torrico	Qualifying tangible personal property by qualified persons primarily engaged manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials

Bill No.	Session	Author	Proposed Exemption
SB 552	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals clean rooms and equipment. Includes optional Bradley-Burns local and district tax exemption
SB 1291	2005-06	Alquist	Materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment

COMMENTS

1. **Sponsor and Purpose.** The author is sponsoring this bill in an effort to encourage the expansion and development of jobs in the manufacturing sector. According to the author, this bill seeks "to boost the state's struggling manufacturing sector by eliminating the sales and use tax on manufacturing equipment to spark job growth and increase California's competitiveness." The author furthers states, "to avoid expanding the state's $25 billion budget deficit, the loss of revenue from the elimination of the sale and use tax would be offset by reinstating the California estate tax that was fully eliminated by Congress and President George W. Bush in 2005."

2. **What types of entities do Codes 3111 to 3399 and 5112 include?** Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, and more.

   Code 5112 is comprised of establishments primarily engaged in computer software publishing or publishing and reproduction. Software publishing establishments carry out the functions necessary for producing and distributing computer software, such as designing, providing documentation, assisting in installation, and providing support services to software purchasers. The software publishing industry produces and distributes information, but usually it "publishes" or distributes its information by methods, such as by CD-ROM's, the sale of new computers already preloaded with software, or through distribution over the Internet, rather than in printed form.

3. **Administrative and technical concerns:**

   - In defining "qualified person," it is recommended that the bill require that the qualifying entity be *primarily* engaged in the activities described in the referenced codes. This is an important issue and one that generated many disputes when the BOE administered Section 6377 previously.

   - Another issue relates to the proposed definitions for the types of property included and excluded from the proposed exemption. For example, on page 4, lines 21 and 28, and page 5, lines 1 and 2, the bill refers to the items having a *useful life* of one year or more (or less than one year). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.

- Subdivision (g) of proposed Section 6377.1 (page 7, line 8) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to new manufacturers' leases of equipment. Since this bill would provide the exemption for all qualifying persons, it appears the limitation in subdivision (g) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

BOE staff is available to work with the author's office to address these and other concerns that may be identified.

4. **Partial exemptions complicate administration of the tax.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, there are currently five partial exemptions in California law, where only the state tax portion (6.25%: General Fund (6%) and Fiscal Recovery Fund (0.25%)) of the state and local sales and use tax rate is exempted. These five partial tax exemptions include: (1) farm equipment and machinery, (2) diesel fuel used for farming and food processing, (3) teleproduction and postproduction equipment, (4) timber harvesting equipment and machinery, and (5) racehorse breeding stock. These partial tax exemptions are difficult for both retailers and the BOE. They complicate return preparation and return processing. And errors on returns attributable to these partial exemptions occur frequently, which result in additional return processing workload for the BOE.

   This measure proposes a 6% exemption (General Fund only), which would create a new exemption category (since current law does not have any partial exemptions other than a 6.25% exemption, which effective July 1, 2011 is reduced to 5.25%). This would require a revision to the sales and use tax return and result in a new, separate computation on the return. Some retailers would have to segregate in their records sales subject to the 6% exemption (proposed by this bill), 6.25% exemption, sales with a full exemption (such as a sale for resale or a sale in interstate commerce), and sales that are fully taxable. This bill would add a new level of complexity, which would create a corresponding increase in errors in reporting the tax to the BOE. This increase in errors would further complicate the BOE's administration of the sales and use tax law and complicate reporting obligations of retailers.

5. **Related legislation.** Similar bills have been introduced this year:

   AB 204 (Halderman) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of equipment by a biomass energy facility, as defined, for use in its biomass energy production activities.

   AB 303 (Knight) would reinstate the partial (General Fund only) sales and use tax exemption for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing.

   SB 47 (Alquist) would provide a partial (General Fund and Fiscal Recovery Fund) sales and use tax exemption for purchases of qualifying tangible personal property used by entities engaged in manufacturing, research and development, newspaper printing, and software production, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.

SB 395 (Dutton and Strickland) would provide a partial (General Fund only) sales and use tax exemption for purchases of certain tangible personal property purchased by qualified persons engaged in manufacturing, research and development, and software production, as specified and defined.

COST ESTIMATE

Because of the *new* partial exemption, the BOE would incur administrative costs attributable to programming, return revisions, and return processing. In addition, the BOE would incur costs to notify affected retailers, prepare a special publication and exemption certificate, audit claimed exemptions, and answer inquires from the public and taxpayers. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The U.S Census Bureau's *Annual Survey of Manufactures* (ASM) reported 2009 (most recent) NAICS 31-33 capital expenditures data (machinery and equipment, buildings, and fuels) for California.

The Census Bureau's *Annual Capital Expenditures Survey (ACES)* reported 2009 (most recent) U.S capital expenditures data (machinery and equipment and buildings) for NAICS 5112. Based on 2007 *Economic Census* data (i.e. the ratio of California to U.S revenue or sales receipts for NAICS 5112), we estimated California capital expenditures for NAICS 5112.

Using the most recent forecast of business equipment investment of IHS Global Insight, a national economic forecasting firm, we estimated expenditures as follows:

California Expenditures
(in billions)

	FY 2011-12	FY 2012-13	FY 2013-14
Manufacturing 31-33	$23.8	$25.3	$26.8
Software 5112	$1.8	$1.9	$2.1
	$25.6	$27.3	$28.9

REVENUE SUMMARY

The revenue impact from exempting tangible personal property purchased by manufacturers (NAICS 31-33) and software publishers (NAICS 5112) from the state sales and use tax (5%) amounts to $0.6 billion in the first six months of 2012, $1.4 billion in FY 2012-13, and $1.4 billion in FY 2013-14.

State Sales & Use Tax Loss
(in billions)

	6 months 2012	FY 2012-13	FY 2013-14
General Fund (5%)	$0.6	$1.4	$1.4

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